



# **OXFORD ANALYTICA**

**CHINA**

**FISCAL TRANSPARENCY**

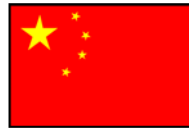
**Country Report 2005**

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# CHINA



## COMPLIANCE RATINGS

<i>Fiscal transparency</i>	2005	2004	2003	2002
Clarity of roles	••	•	•	•
Availability of information	••	••	••	••
Budget preparation	••	••	••	••
Accountability	•	•	•	•
<b>Score</b>	<b>1.75</b>	<b>1.50</b>	<b>1.50</b>	<b>1.50</b>

## OUTLOOK & COMMENTARY

Fiscal transparency over the past year in China has continued to improve, although at a slow pace. Progress is needed in strengthening the Treasury Single Account and in the classification of budget expenditure. The Ministry of Finance (MoF) plans to classify financing and debt according to the IMF GFS 2001 manual gradually; a full rollout of the new classification system was scheduled for mid-2005, but this has not yet happened. Once this is completed, the transparency of the budget should increase markedly.

There is a need for the clarification of the roles and responsibilities of the public sector authorities and increased coordination. The current delineation of roles and responsibilities of the various levels of government remains unclear. A further problem is that local government structures are burdened by heavy spending obligations without appropriate matching revenues or an effective system of transfers. A law on fiscal transfers is currently under discussion, although it is uncertain when this will be approved.

## EXECUTIVE SUMMARY

### 1.75 Intent declared

Fiscal transparency over the past year in China has continued to improve, though at a slow pace. China subscribes to the IMF General Data Dissemination System (GDDS). Classification of budget expenditure and coverage is currently weak, but the Ministry of Finance (MoF) plans to classify financing and debt according to the IMF GFS 2001 manual. A full rollout of the new classification system was scheduled for mid-2005, but this has not yet happened. China is currently running pilot schemes in six provinces and several cities with the new budget classification system. A new budget law is currently being considered, but the details of the law have not yet been made public, and the timetable for the passage of the law is not clear. New debt management procedures should be introduced to improve information on, and tracking of, government debt and contingent liabilities. The MoF is conducting research in this area, particularly regarding local government debt, but there have been no concrete policy improvements over the past year. Progress is also needed in strengthening the Treasury Single Account.

The government's annual budget makes projections that are typically overtaken by developments and some items appear to be left off or hidden within the national accounts. Budget data do not accurately capture all state revenues and spending. Central and local levels of government have numerous extra-budgetary categories that are not subject to central control. The result has been poor fiscal transparency at the local level. As noted by the IMF, the budget law prohibits sub-national governments carrying out direct borrowing or issuing guarantees; however, in practice they are able to establish fully or partially owned companies which can borrow from banks. This creates contingent liabilities for local governments, which are poorly monitored. China lacks a system to measure fiscal risk management, and the government does not have complete information on its contingent liabilities. Fiscal policy objectives are not clearly explained in the available documentation. China continues to work towards building a multi-year budget framework and an efficient performance evaluation system for spending programmes.

Recent reforms in the fiscal arena have contributed towards streamlining the tax system and strengthening the tax administration. There are some adequate pilot programs in place, but progress is slow and unclear. There is a need to develop a unified, streamlined computer system to integrate the varied functions of tax collection and administration. The overall pattern is that tax collection is increasing. The MoF has introduced ten new accounting standards since 1997, but its intention to meet international best practices by 2004 remains unfulfilled, and there has been little progress in this respect over the past year.

The data released by the National Bureau of Statistics (NBS) are increasingly comprehensive, though the accuracy of statistics is still questionable. There have, however, been improvements in the quality of economic statistics over the past year. As noted by the IMF, a continuing priority for further improvement is the compilation and timely publication of annual and quarterly real GDP data on an expenditure basis.

China's overall score has increased from 1.50 in 2004 to 1.75

## 1. CLARITY OF ROLES, RESPONSIBILITIES AND OBJECTIVES



Intent declared

**The government sector should be distinguished from the rest of the public sector and from the rest of the economy, and policy and management roles within the public sector should be clear and publicly disclosed.**

### Structure, functions, and responsibilities of government

The relationship and distribution of responsibilities between the government, the public sector and the rest of the economy in the People's Republic of China (PRC) are subject to significant shortcomings and an overall lack of transparency. General policy and management roles within the public sector are loosely set out by various government departments or in law. However, practice differs significantly from what is laid out in the law. For administrative purposes, the constitution divides the country into provinces, autonomous regions, and municipalities.<sup>1</sup> There are 31 provincial-level administrations, including the four provincial-level municipalities of Beijing, Shanghai, Chongqing, and Tianjin; 331 prefectures; 2,109 counties; and nearly 45,000 towns.<sup>2</sup>

The highest organ of state power is the National People's Congress (NPC), whose Standing Committee takes care of NPC matters when the Congress is not in full session. The Congress and Committee are the national legislature. The constitution specifies the functions and powers of the legislature, conditions for representation in the legislature, and terms of office.<sup>3</sup> The State Council is the executive body of the NPC and the highest organ of state administration. Its functions and powers are set out in the constitution.<sup>4</sup> The judiciary is represented by the people's courts, of which the Supreme People's Court is the highest judicial organ.<sup>5</sup>

The state is charged with bringing about the consolidation and growth of the state economy.<sup>6</sup> These provisions suggest a clearly defined structure, but the de facto distribution of power and administrative responsibility is more ambiguous owing to the extensive control exerted by the Communist Party in all policy areas. The Politburo's Standing Committee sets and manages long-term policies and responds to external and domestic problems as they arise. The NPC's main role is to endorse decisions made by the Politburo and the Party, and thereby imbue them with official legitimacy. In recent years, the NPC has become more vocal about certain policies, but it still largely endorses policy decisions made by the Communist Party.

### Coordination and management of budgetary activities

There is significant room for improvement in the coordination of budgetary activities performed at the different levels of government. The Ministry of Finance (MoF) manages only the recurrent budget, while the National Development and Reform Commission (NDRC) -- which has taken over and superseded the functions of the former State Planning and Development Commission (SPDC) -- falls under the State Council, and is in charge of the capital budget. Commentators noted that rivalry between the NDRC and the MoF is hindering coordination, although the MoF insisted that the NDRC and MoF coordinated in drawing up the budget.<sup>7</sup> Staffing decisions, which have major spending implications, are made by the State Commission Office for Public Sector Reform, apparently with little consultation with fiscal authorities. There is a need for the clarification of the roles and responsibilities of the public sector authorities and increased coordination to address the organisational problems resulting from the fragmented structure outlined here.<sup>8</sup>

The processes of budget compilation and implementation are highly politicised, involving ongoing negotiations between government departments and the MoF, adjustments during the fiscal year, and ad hoc arrangements at all levels of government.

The delineation of roles and responsibilities of various levels of government is unclear. Formally, the central government is responsible for spending on defence, economic restructuring, and other projects needed to achieve macroeconomic objectives agreed to by the Politburo. Local governments are in charge of the remaining spending, from education to social insurance. Local governments are given budget targets, but these are not binding. As long as they can fund additional spending with additional revenues, the centre will not intervene.<sup>9</sup> Local government structures are burdened by heavy spending obligations without appropriate matching revenues or an effective system of transfers. A law on fiscal transfers is currently under discussion, but it is uncertain when this will be approved.<sup>10</sup> Capital spending at the local level is not tightly controlled by the central government, but only influenced by it. However, the central government has increasingly been drawn into aiding local authorities with social welfare outlays, and it made ad hoc fiscal transfers to settle outstanding pension obligations in certain provinces in 1998 and 1999. As noted by the IMF, ‘recentralisation of revenues, limited formal local tax autonomy, and own-source revenues in the face of an excessive expenditure burdens has created incentives for local governments to engage in “creative accounting” and to extract resources from the central government while offloading liabilities (local governments can resort to state-owned enterprises (SOEs) for both delivery of services and debt financing).’ The result has been poor fiscal transparency at the local level.<sup>11</sup>

While there is a legal framework in place for budgetary activities, the budget misses much of the extra-budgetary activities of the government. Non-tax revenues, tax expenditures, payments arrears, quasi-fiscal expenditures through SOEs, and directed credit to SOEs are not listed in the formal budget.<sup>12</sup> These omissions from the budget limit the usefulness of this document as a reliable indicator of the government’s overall fiscal position.

Formally, the Budget Law of 1994 sets out the budgets of all levels of the Chinese government; functions and powers for budget management; the scope of budgetary revenues and expenditures; the compilation of the budget; the examination and approval of budgets; and other related aspects.<sup>13</sup> This resulted in a new framework for budget revenues allocation and expenditure responsibilities assignment between levels of government. The State Council and the MoF have also issued a set of regulations with detailed guidelines on the implementation of the budget. However, commentators have indicated that a more efficient system of fiscal transfers is required, both between the provinces and the centre and within the provinces.<sup>14</sup>

### **Relations between government and public sector agencies**

In China’s hybrid planned and market economy, the line between the government and the rest of the public sector is not clear. The formal public sector consists of the central government and its four subordinate tiers of government. However, there are an estimated 300,000 SOEs with more than 51% of the shares held by municipal, provincial or central government. SOEs are generally perceived as lacking transparency, with weak internal and external controls, accountability systems and appropriate managerial incentives. As noted by the IMF, SOEs have become more market oriented of late, although further reforms are needed.<sup>15</sup> In addition, there are numerous quasi-governmental agencies. In recent years, many Chinese government agencies set up commercial ventures to fund public projects. This could lead to conflicts of interest and diminish the agencies’ ability to perform their function as the provider of public goods.<sup>16</sup>

In February 2004, the State Assets Supervisory Commission (SASAC) ruled that all transfers of state assets must be hosted by a property rights trading centre (PTRC), and that asset sales by the central enterprise groups that it owns (of which there are about 180) have to be hosted by one of the three largest PRTCs: Beijing, Shanghai and Tianjin. If this ruling holds, the PRTCs will play a crucial role in one of the most important economic challenges currently

facing China: how to privatise its industry efficiently and fairly.<sup>17</sup> Some of the PRTC's have established websites to publish information on state assets for sale.

While the creation of the SASAC augurs an improvement in SOE management and, potentially, greater success in sales of state assets, the overall approach guiding SOE reform remains a fundamental weakness. SOEs are not seen as having to justify their existence in economic terms. The SASAC could do this, for example, by requiring them to pay dividends. There is little prospect of this happening. For all the change in SOE oversight, centrally planned economic thinking prevails.<sup>18</sup>

### **Government involvement in the private sector**

In China, the issue of state involvement in the private sector concerns the gradual introduction of private enterprise into an economy based on state ownership and control. In March 1999, the constitution was amended to elevate the status of private enterprises from a 'complement' to an 'important component' of the economy. In August of that year, the NPC passed the country's first Sole Proprietorship Law that regulates and protects private enterprise. At the 16th Party Congress, held in November 2002, the constitution was amended to declare that private enterprise represented "advanced productive forces". These amendments provide legal and political protection to the private sector. However, private enterprises still have difficulty getting bank loans and are banned from investing in industries that are classified as "strategic".

Moreover, the establishment of modern economic enterprises has created a demand for improving the structure of corporate governance in China. Over the past decade, the country has put into place a basic legal framework to underpin the corporate form, including company, contract, accounting and securities laws. The Administrative Licensing Law passed by the NPC in 2003 took effect in July 2004. Spurred by WTO accession, the law is intended to aid private sector development by making administrative procedures more transparent and limiting the arbitrary power of local officials over licences and project approvals. It is too soon to judge whether the law has made a discernable impact, although there are signs that in some cases judges in commercial disputes are willing to cite it in their findings.<sup>19</sup>

There are still significant problems in understanding the operating legal regime -- there remains a plethora of unpublished quasi-legislation such as "circulars" and "notes". More positively, the investment process has shifted from an approvals system to a registration system. The applying firm conducts a feasibility study, which is repeated by the NDRC. This is a move towards a monitoring, and away from an arbitrary, role.<sup>20</sup> The SASAC and the NDRC are on an equivalent level in the government hierarchy. The NDRC has less say in state assets but it still must approve large SOE investment projects. The NDRC is also in charge of the programme for revitalising the northeast.

## **There should be a clear legal and administrative framework for fiscal management.**

### **Legal framework for budgetary activities**

The 1994 Budget Law governs the budgetary process, and specifies budget roles and responsibilities. Budgets are managed separately at the different levels of government. Altogether, there are five levels of budgets, from the central level downwards. The national budget is composed of the central government budget and local government budgets. The MoF and local government finance bureaux prepare the central and local budgets and final accounts, respectively. They are responsible for the preparation and implementation of budget-adjustment plans.

### **Legal framework for taxation**

In a comprehensive tax reform in 1994, the government introduced a revenue-sharing system that divided revenue sources into central, local, and shared taxes. Taxes assigned to the centre include domestic excise taxes, customs duties, and value-added tax (VAT) and excise taxes on imports. Local taxes include business tax, urban land use tax, and real estate tax. VAT is shared, with the centre obtaining 75% of the revenue.<sup>21</sup> However, local governments have limited autonomy in taxation matters, despite their substantial expenditure commitments. Falling revenues at the central level and rising expenditure commitments at the sub-national level have pushed both tiers of government to use other means, such as user charges and administrative fees for public services, to raise the necessary funds to finance expenditures.<sup>22</sup> Moreover, many local governments have started providing tax concessions to attract investors.

Ten years on, tax revenues have improved markedly.<sup>23</sup> The 'Golden Tax' project and the 'Chinese Tax Administration and Information System' (CTAIS) are going through their third stage of implementation. The Golden Tax information system has been in the experimental phase since 1998. Regional and technical problems are preventing its further application. The State Administration for Taxation (SAT) in 2004 was given more budget funds to help, but the problem is that the government makes negative returns on this project: more is spent on implementation than will be earned from tax revenue. The State Council seems unable to force through a unified taxation system; they allow local governments to set their own systems, which the SAT then verifies. There are numerous IT problems. While some progress has been made in certain localities regarding data and analysis for tax collection, it is proving very costly.<sup>24</sup>

The SAT, created in 1994, is charged with the rationalisation of tax administration, but its effectiveness has been limited by its inadequate technology and shortage of qualified personnel. The SAT functions like a government ministry or agency, but it has no real independence and is often headed by a former vice minister of the MoF. The SAT and the MoF have been working together in order to develop a better tax legislation framework and improve policy implementation.

Recent fiscal reforms have contributed towards streamlining the tax system and strengthening the tax administration. There are some good pilot programmes in place, but progress is slow and unclear. Local tax administration offices are being allowed to attempt tax reforms (such as streamlining tax administration), and the MoF is monitoring these schemes for their success/applicability to other provinces. Efforts at the national level are currently at the strategising stage, rather than implementation. There is a need to develop a unified, streamlined computer system to integrate the varied functions of tax collection and administration, and to develop appropriate training. The national administration is currently running on two incompatible computer systems; one with nationwide coverage that has little functionality, and the other that is much more user-friendly but which does not have nationwide coverage.<sup>25</sup>

The overall pattern is that tax collection is increasing; as a percentage of GDP tax revenues stand at 20%. Collection of VAT and personal and corporate income tax is increasing. This indicates that the tax authorities are being allowed to press for reduced tax evasion without interference from the authorities.<sup>26</sup> More generally, the national tax administration is not free from political direction. Commentators expressed concern about the procedures that the authorities in charge of investigating tax evasion carry out; particularly because the system is not sufficiently sophisticated to effectively investigate high-income earners, and that the authorities that do investigate tax evasion are often corrupt.<sup>27</sup> There have also been cases of tax officials being subjected to threats, violence and political intervention while carrying out their duties, although they are usually offered adequate protection by the state. The ongoing reform of the tax administration is likely to contribute to increasing transparency over the medium term.

A revised Personal Income Tax Law was passed by NPC in October 2005. It raises the threshold for monthly personal income tax, from 800 Rmb per month to between 1200 Rmb and 1500 Rmb, in order to help ease the

burden on low-wage earners. The amendment will take effect from next year. Payment of personal income tax has not been consistently enforced up until now. There was a public forum held to discuss the law, which was a positive step for transparency. Some commentators suggested that this event was stage-managed (that the people who attended had been handpicked and their opinions vetted).<sup>28</sup>

### **Ethical standards for public servants**

The Provisional Regulations on Civil Servants, issued by the Ministry of Personnel in 1993, declare that government officials must abide by and execute their duties in accordance with the constitution and relevant laws and regulations. The government is trying to tackle systemic corruption by improving the legal environment. In addition, it has initiated several campaigns to crack down on corruption among civil servants, including personnel in the treasury departments. However, corruption among public servants remains high. A major problem in China is a lack of training for both judges and lawyers, diminishing the enforcement of new legislation.

By some accounts, the current government is more aggressive in fighting corruption than the government it replaced, and has identified corruption as a serious threat to retaining power. Recent arrests of high-level officials are an example of this. Prime Minister Wen Jiabao's anti-corruption report to the NPC was seen as crucial in the anti-corruption effort. Concerns about corruption are driving a large part of the fiscal reforms. Sparked by the 1999 internal report commissioned by Zhu Rongji, these reforms received a major boost from the publication in June 2004 of the National Audit Office Report on the Execution of the 2003 PRC Budget, which brought unprecedented transparency to the budgetary process at both the federal and local levels. Yet in doing so, it highlighted through a variety of case studies the perniciousness of corruption, which thrives on opacity in the budgetary process.<sup>29</sup>



## 2. PUBLIC AVAILABILITY OF INFORMATION

●● Intent declared

**The public should be provided with full information on the past, current, and projected fiscal activity of government.**

### Central government operations

In April 2002, China joined the IMF General Data Dissemination System (GDDS), which requires greater transparency in the provision of macroeconomic statistics. The MoF plans to classify financing and debt according to the IMF Government Finance Statistics (GFS) 2001 manual. A full rollout of the new classification system was scheduled for mid-2005, although this has not yet happened. China is publishing more data in order to comply with the GFS, but the current classification system is poor -- meaning incremental changes have a limited impact. China is currently running pilot programmes in six provinces and several cities with the new budget classification system. There has been no progress in debt reporting over the past year.<sup>30</sup>

The National Bureau of Statistics (NBS) publishes monthly and quarterly fiscal data. These statistics are supplied by the MoF and published by the NBS in both English and Chinese in the *China Monthly Economic Indicators Bulletin*. More detailed annual data are available in the *China Statistical Yearbook* from the NBS, and the *China Finance Yearbook* and *China Financial Outlook* from the MoF, which are also available on the ministry website.<sup>31</sup>

The MoF reports total annual fiscal revenues and expenditures, breaking them down into a few major categories. It provides similar annual figures for the country's 31 provinces and municipalities. Some data on extra-budgetary revenues and expenditures are also available, although they are not as detailed as the national budgetary figures. Extra-budgetary expenditure grew from 2.6% of GDP in 1980 to 5.7% of GDP by 1996, before declining to 4.1% in 1999. Independent audits by the MoF and the National Audit Office estimate these funds and fees in the range of 8-10% of GDP. In 2004, key spending streams remained off-budget, notably in education and healthcare.

The considerable degree of extra-budgetary activities and quasi-fiscal expenditures through state banks and SOEs is a by-product of the economic reforms that China has implemented in its transition to a market economy since 1979. These economic reforms have opened up a sizeable fiscal gap between falling revenues and unchanged expenditure commitments at the centre, effectively devolving service delivery to the sub-national level. Revenue collection efforts have been substantially enhanced, and central revenues as a share of GDP have risen steadily in recent years.

In its annual budget, the MoF provides the outturn of the preceding fiscal year, but it does not make budgetary forecasts beyond the upcoming fiscal year. The documentation does not describe the nature and fiscal significance of the central government's contingent liabilities and quasi-fiscal activities. It makes some forecasts of its contingent liabilities, but these are not released publicly and are much lower than unofficial estimates.

### Public sector operations

China has five levels of budgets at the central, provincial, municipal, county, and township levels. Local budgets are approved by the corresponding level of the People's Congress -- with complete autonomy from the central government -- and are submitted to the MoF for record and compilation of the state budget.<sup>32</sup> The national Budget Law stipulates that drafts of the central and local budgets, and any amendments, must be reviewed and approved by

the NPC and local congresses. In addition, the state budget usually includes three parts, namely the national budget, the central budgets and local budgets. Local budgets are publicly available (in Chinese only) in the *Finance Yearbook*, on an annual basis. Some sub-provincial budgets are available (in Chinese only) through the local statistical yearbooks.

However, the finances of SOEs and other state-owned assets are not included in the state budget and are dealt with separately by the NDRC. Commentators suggested that the key issue in terms of transparency is the ability of China's different tiers of government to improve governance through reforms in the medium term.<sup>33</sup>

## **A commitment should be made to the timely publication of fiscal information.**

### **Debt reporting**

The People's Bank of China publishes summary quarterly and annual data for the level and composition of the government's debt and financial assets in its *Financial Outlook* and *Annual Report*. The MoF uses its publications and website, as well as the NBS, to disseminate more information on the country's debt situation. It publishes summary data on overall debt levels for the past ten years, showing debt dependency of the central government budget, debt outlays as a share of fiscal expenditures, debt income as a share of fiscal revenues and the country's overall external debt. The data on government debt includes domestic borrowing, foreign borrowing, outstanding debt and the payment of principals and interest. Availability of information in English is very limited.

China's intergovernmental system has given rise to dysfunctional behaviour, such as indirect borrowing. Although forbidden to borrow openly, local governments have attempted to do so through window corporations and banks. As a consequence, the central government is not in a position to monitor or manage gross public debt.<sup>34</sup>

Since 2000, the MoF has been disseminating data on interest payments on its domestic and foreign bonds. In 2001, it made public for the first time its outstanding national debt. With China's participation in the IMF GDDS, the MoF plans to classify financing and debt according to GFS 2001. A full rollout of the new classification system was scheduled for mid-2005, though this has not yet happened. China is currently running pilot schemes in six provinces and several cities with the new budget classification system.<sup>35</sup>

There have been calls by international organisations for China to introduce new debt management procedures to improve information on and tracking of government debt and contingent liabilities. The MoF is conducting research in this area, particularly for local government debt, but there have been no concrete policy improvements in this respect over the past year.<sup>36</sup>

### **Advance release calendars**

The MoF states that its responsibilities include promoting the distribution of fiscal information.<sup>37</sup> However, the public dissemination of fiscal information is very limited. The ministry does not disseminate an advance release calendar. Meanwhile, the NBS puts out press releases on fiscal aggregates of the central government approximately ten days after the reference month.

### 3. OPEN BUDGET PREPARATION, EXECUTION AND REPORTING

#### ●● Intent declared

#### **Fiscal policy objectives, macroeconomic framework, and risks**

##### **Fiscal policy objectives**

The NDRC and the MoF are in charge of establishing fiscal objectives, and providing analyses of the financial situation. Moreover, the NDRC is also tasked with participating in the formulation of fiscal and monetary policies. However, fiscal policy objectives are not clearly explained in the documentation publicly available.

For decades, a key objective of the budget was to channel revenues to state firms, so that they could produce the goods and services needed by the centralised economy and the jobs and social welfare services needed by the urban population. In return, state firms surrendered most of their profits to the Treasury. However, as the importance of the state sector shrank, the budget gradually moved away from funding the state sector to financing newly established social services for redundant workers, poor farmers, and pensioners. Since 1998, the budget has taken on a new role, namely the promotion of economic growth through government spending. The MoF has issued renminbi (Rmb) 150-210 billion of Treasury bonds each year to fund government-designated infrastructure projects needed to attain the annual GDP target growth of 7%. It has clearly spelt out this objective in its annual budget in recent years. Occasionally, the MoF publishes ad hoc statements and updates on its progress in meeting fiscal policy objectives. However, the emphasis of these reports is on how the MoF is meeting its revenue and expenditure targets, rather than the quality and progress of its work.

The government states that it aims to have a balanced budget, a goal difficult to achieve given its persistent budget deficit since 1997. There are also other fiscal rules on mandatory spending increases for under-funded social sectors such as education, agriculture, health care, science and environmental protection.

##### **Macroeconomic framework**

Among the functions of the NDRC is preparation -- on behalf of the State Council -- of the macroeconomic framework used in the budget process. However, the targets listed in the plan are not binding and have no operational functions. Moreover, the NDRC also has to study and analyse the economic situation and its development both in the country and abroad, issues concerning national economic security, put forward policy recommendations on macroeconomic management, and coordinate economic and social development.

In addition, macroeconomic forecasting is a joint responsibility of the NDRC and the People's Bank of China (PBC). The NDRC also prepares a rolling five-year investment plan. Despite the close relationship between macroeconomic forecasting, fiscal forecasting, investment planning and budget preparation, the level of consultation between the NDRC, the PBC, and the MoF is weak.<sup>38</sup> This lack of coordination between various government agencies may explain the poor quality of fiscal projections in China.

##### **Fiscal risks and sustainability**

There is currently no system in place for effective fiscal risk management in China. The government does not have complete information on its contingent liabilities stemming from the quasi-fiscal financing of infrastructural projects

through SOEs, the social expenditure needs of SOEs, and the country's under-resourced pension funds. The central budget does not include all government-guaranteed debt and the costs of debt servicing, and this makes it impossible for the MoF to report the total level of outstanding debt.

Recapitalisation of the state banks in January 2004 was funded by central bank reserves, but it will need to be reflected in the budget. The liability entailed in the government's new explicit ownership stake in the central bank also demands greater transparency and accountability. At present, neither the MoF nor the State Council has adequate assessments of the fiscal risks stemming from the costs of restructuring SOEs and loan guarantees given to SOEs.<sup>39</sup> In addition, for this reason no assessments are available of the fiscal sustainability of the budget.

## Budget presentation

The National Budget Law stipulates that drafts of the central and local budgets and any amendments must be reviewed and approved by the NPC and local congresses.<sup>40</sup> The budget year is the same as the calendar year, starting on 1 January and closing on 31 December. Budget preparation is not fully integrated with the fiscal cycle, taking place late in the fiscal year, and with a lack of coordination between the central, provincial and sub-provincial levels.<sup>41</sup> As the NPC only meets in plenary session in March, the budget is not enacted until well into the fiscal year. The government presents the budget proposal to the NPC at the beginning of the plenary session in March, and the NPC has two weeks to deliberate.<sup>42</sup> Although the NPC can only approve or reject the budget in total and cannot amend it, the Congress has been having an increasing influence during the parliamentary budget process, which starts in January every year. However, the MoF usually adjusts the budget throughout the fiscal year with little consultation with the NPC.

The NPC in 2001 set up a working committee for the budget. Since then, there has been increasing communication between it and the MoF. Since 2002, the MoF has been giving more information to NPC delegates. More government agencies have been submitting budgets to the NPC, rising from four in 2001 to 26 in 2002. By 2003, all top-level agencies submitted budgets. The NPC budget committee has regular exchange of information with the MoF, and has been more deeply involved in budget compilation than previously. The starting point of the budget process is now October 10 -- a big improvement from the previous starting points of December and January. The NPC is involved earlier on, and in more stages of the budget process.<sup>43</sup> Nevertheless, it is systematically undermined by the underestimation of revenue in departmental budgets as un-projected revenues can be spent without NPC approval.<sup>44</sup>

## Data reporting

Budget data are reported on a gross basis, differentiating revenues from expenditures. Revenue data given in the *China Statistical Yearbook* refer to revenues actually collected by the central and local governments and exclude revenues from domestic and foreign borrowings. Since 1999, interest paid on domestic and foreign debts has been included in expenditure statistics, with the interest payment and principal of new debt issues classified under separate headings. Previously, they were grouped together under a single expenditure item.

Budget documentation and final accounts cover all budgetary and some extra-budgetary activities of the government. The government prepares a consolidated balance sheet that also includes information on the level and composition of its debt. This information is made public through publications such as the *China Statistics Yearbook*. The NBS states that procedures for the compilation of extra-budgetary revenue and expenditure data are approximately the same as those for final state accounts.

## **Budget execution and monitoring**

A major improvement of recent years includes technical centralisation of money flows through the Treasury Single Account (TSA). Over half of expenditure now goes through a central Treasury account, compared to virtually zero at the beginning of the decade, with three-quarters of government agencies' spending going through the TSA. Provinces are also starting to set up single treasury accounts. Sichuan Province is leading in the adoption of TSA with 20 other provinces studying, to some degree, their implementation effort.

A new budget classification system and changes in the chart of accounts are necessary for transparency, accountability and control of government spending, as well as for making fiscal policy a tool of macroeconomic management. The government's annual budget makes projections that are typically overtaken by developments and some items appear to be left off or hidden within the national accounts. This raises questions about the relevance of official targets and of the government's annual accounting exercise.<sup>45</sup>

Budget data do not accurately capture actual state revenue and spending. Additional efforts are needed to move extra-budgetary funds, especially at the local level, on to the budget. Governments at different levels circumvent the budgetary process by spending off-budget. Central and local levels of government have numerous extra-budgetary categories of revenue and spending. These include: administrative fees; large amounts of military spending, especially on high-tech projects; institutional fees; funds handed upwards by subordinate institutions; funds raised by local governments; and social security funds, which are growing rapidly as the state decouples welfare from the day-to-day costs of enterprises. Almost all infrastructure investments are financed off-budget and are poorly tracked.<sup>46</sup>

The budget law prohibits sub-national governments carrying out direct borrowing or issuing guarantees; however, in practice they are able to establish fully or partially owned companies that can borrow from banks. As noted by the IMF, 'this in turn creates contingent liabilities for local governments, which given the absence of a systematic and comprehensive management system for monitoring, is less easily controlled than explicit government borrowing. The use of extra-budgetary funds and off-budget sources, which allow local governments to maintain considerable resources outside the official budget and not subject to central control, represents another informal tool of fiscal policy. These informal activities detract from the accountability and transparency of the fiscal system, and create significant future risks.'<sup>47</sup>

Reforms in intergovernmental fiscal relations have been incremental in scope; this piecemeal approach does not take into account the interrelationships and overlaps that exist among the various areas of fiscal activity such as expenditure and revenue assignments, intergovernmental transfers, and sub-national borrowing and debt.

The IMF has identified key weaknesses in four areas of intergovernmental fiscal relations in China: expenditure assignments, revenue assignments, intergovernmental transfers, and fiscal management. Despite recent reforms, official coverage of sub-national fiscal activities remains incomplete and a systematic and comprehensive management system of direct and contingent liabilities at the local level with concomitant information for the central government is lacking. Budget reforms at the sub-national levels lack adequate scope and are not comprehensive.<sup>48</sup>

Budget execution and monitoring are overseen by a number of departments in the MoF. While funding requests are screened vigorously, the effectiveness of expenditure is not monitored properly. The Treasury transfers budget funds to the multiple accounts of the spending units through various layers of bureaucracy, and this makes it difficult to trace the flow of funds through the government sector. The transfer of funds is only reconciled with bank account statements before the compilation of the final accounts.

Owing to the under-developed nature of China's internal control system, it is very difficult to trace the flow and use of public funds throughout the government sector. Moreover, the central government lacks the instruments to track expenditures made by sub-national bodies with direct financing from the centre. On top of leakages that occur due to extra-budgetary activities, substantial waste and misuse of contingency funds have also weakened the efficiency of the budgetary process.<sup>49</sup> After the reorganisation of the MoF in 2000, the monitoring of budget execution was divided among four departments: Budget, Public Expenditure, Capital Construction and Fiscal Supervisions. These reforms strengthened the budget monitoring process, but further reforms are needed to improve the transparency of the use of public funds in China.

China continues to work towards building a multi-year budget framework and an efficient performance evaluation system for spending programmes. The MoF has developed a multi-year budget framework for broad parameters of its budget, which has proved to be helpful in the formulation of broad policy. More major improvements in this area are likely to begin with a pilot scheme.<sup>50</sup> There is also a need for a more effective system to evaluate government policies, programmes and spending. In terms of expenditure management, and performance-based budgeting in particular, China is aiming to introduce a system akin to those of Australia and New Zealand.<sup>51</sup>

### **Accounting basis**

The 1985 Accounting Law and the associated Government Uniform Accounting System regulates government accounting and reporting practices. The accounting system is cash-based. The state budget does not record assets, arrears or details of the transactions of spending units. The Accounting Department of the MoF is responsible for supervising accounting operations nationally; making policy recommendations on accounting reform; and formulating and implementing accounting decrees, regulations and standards.<sup>52</sup> The MoF has introduced ten new accounting standards since 1997, but its intention to meet international best practices by 2004 remains unfulfilled, and there has been little progress in this respect over the past year. The authorities are thinking about experimenting within central government agencies with accrual-based accounting. They are currently conducting pilot programmes in certain provinces; this has attracted the interest of other provinces. The benefit of having one is clear to the Chinese authorities, as they would be able to monitor exactly where the funds are going.<sup>53</sup>

### **Procurement and employment**

On 29 June 2002, China promulgated the Government Procurement Law which sets out the rules and procedures for the purchase of goods, construction works and services by governmental and quasi-governmental entities. This new law is expected to improve fiscal transparency by eliminating the last vestiges of the compulsory procurement system, which had characterised China under the planned economy. This legislation is also part of a larger government effort, which began in 1998, to reduce corruption through transparent bidding processes; the elimination of improper affiliations between businesses, the government and the military; and greater accountability for public infrastructure projects.

In order to improve accountability, local governments have started to use performance contracts. Performance evaluation includes various methods (top-down, peer review and bottom-up) and a system of rewards tied to performance. In addition, the Administrative Licensing Law came into effect in July 2004. This is intended to improve the licensing of business by local governments, reducing their discretionary powers and decreasing the scope for corrupt practices. This law is expected to play an important role in introducing a more transparent and efficient administrative system with standardised practices and good coordination.<sup>54</sup>

Since the 1980s, policies have lowered the average age of government officials while increasing education levels, especially among senior officials. Since 1993, civil service reform has focused on improving the capacity of the bureaucracy through new selection procedures that emphasise openness and competition. In addition, the government has promoted impartiality and integrity as core values of the civil service, and corruption allegations

have been investigated even at a senior level. However, as the 2004 report on the audit of the 2003 budget execution made clear, corruption within the state bureaucracy remains a serious problem.

## **Fiscal reporting**

Legislative oversight of the budget process, although poor, is improving. The NPC in 2004 worked with more government departments to improve transparency and accountability. It enforced a nominal cap on the 2005 budget. The budget process is typically not completed until March, three months into the budget year. Government departments routinely underestimate revenue projections, so that the surplus unbudgeted revenues can be spent without NPC oversight. In this context, more accurate revenue forecasts would empower the NPC and facilitate its supervisory functions. The NPC also needs to be brought into the budget-making process at all levels.

The Chinese accounting system requires that the Treasury report its revenues, expenditures and account balances to the MoF on a daily, monthly, and annual basis. Spending agencies report monthly and annually to their supervising ministries, which compile reports for the MoF. Computerisation of government budgeting and accounting remains a work in progress.

Fiscal data are reported during the year through the MoF's publications, and the website and press releases of the NBS. The finance minister also reports to the standing committee of the NPC several times a year on the progress of the MoF's work. While the procedures for fiscal reporting are firmly in place, the lack of capacity for effective internal control reduces the transparency and efficiency of fiscal processes in China.



#### 4. ACCOUNTABILITY AND ASSURANCES OF INTEGRITY

##### ● No compliance

##### Data quality standards

Fiscal data quality suffers from the multiple layers of bureaucracy in China. Officials are widely seen as wanting to further their own interests to the detriment of the accuracy of the figures they submit to higher authorities. Local governments have a strong temptation to exaggerate their spending commitments and under-report the revenues they collect. Moreover, the system of fiscal data collection is archaic, and there is a lack of reconciliation of figures from other sources.

The most comprehensive set of fiscal data is found in the National Bureau of Statistics Yearbook, which has figures dating back to 1978. The NBS has made several adjustments to the statistics over the years, taking into consideration the impact of recent fiscal reforms. The annual budget and final accounts are cost-based. The standards used in the compilation and presentation of budget data are not publicly available. Moreover, there are no specific assurances of the quality of fiscal data. The collection of fiscal data is not sufficiently computerised, and time lags are substantial. However, the World Bank and the IMF have been providing technical assistance to the MoF and the People's Bank of China respectively, and this is expected to contribute to the gradual improvement of data quality over time. The data released by the NBS are increasingly comprehensive, although the accuracy of data is still questionable.<sup>55</sup>

There have been improvements in the quality of economic statistics over the past year, but there is still a significant lack of data in several areas. As noted by the IMF, a continuing priority for further improvement is the compilation and timely publication of annual and quarterly real GDP data on an expenditure basis. Improvements are also needed in the area of balance of payments statistics and labour statistics. There is a need to adopt a revised budget classification system and to expand the coverage of the treasury single account.<sup>56</sup>

##### Independent scrutiny of fiscal information

##### Independent Audit

The Chinese National Audit Office (CNAO) is responsible for auditing the revenues and expenditures of all departments under the State Council.<sup>57</sup> The Auditor General, appointed by the prime minister, is a member of the State Council. In recent years, the office has evolved into a zealous watchdog that monitors the use of public funds at all levels of government. In his recent reports to the National People's Congress, the Auditor General criticised Treasury officials, especially those at the lower levels, for misappropriating, wasting and even embezzling public funds. In June 2004, Auditor General Li Jinhua told the NPC Standing Committee that 1.4 billion renminbi (170 million US Dollars) from the 2003 budget had been misused.

The MoF has a think tank, the Research Institute of Fiscal Science, whose specialists advise on fiscal matters. Private economists from leading academic institutions, such as the Chinese Academy of Social Science, also offer their advice publicly and privately to the MoF.

China has drafted accounting and auditing laws and rules that comply with international practice. However, the enforcement of these standards remains weak, and more efforts in terms of implementation should be made.



Increasing the frequency and scope of auditing, and enhancing the professionalism of auditors, are among the main issues to be addressed. In addition, the introduction of penalties for non-compliance with the regulations in place will also have to be addressed.<sup>58</sup>

### **National Statistics Agency**

The National Statistical Law, adopted in 1983 and revised in 1996, requires statistical work to be carried out in an effective, timely, and accurate manner.<sup>59</sup> In recent years, the statistical system has improved its reliability. However, the NBS has neither sufficient human resources nor the expertise to perform its job effectively in China's increasingly complex fiscal environment.

The NBS is committed to improving its statistics to meet the requirements of the IMF GDDS, and a special working group for this purpose has been set up within it. Plans include more effective implementation of the Statistical Law to avoid misreporting of the data, and the strengthening of follow-up audit checks on enterprise data and similar checks on the data provided by provincial statistical offices. Further training is also planned for NBS staff to enhance their awareness of data quality issues pertaining to data integrity and professionalism. However, no detailed timeframe has been provided for these reforms.

Significantly, the NBS's recent Economic Census -- the first since 1992 -- will provide a crucial new baseline for economic statistics, particularly in the national accounts. The census is currently being audited and the results will be available in early 2006.<sup>60</sup>

The data released by the NBS are increasingly comprehensive, although the accuracy of statistics is still questionable. Data are not disseminated on a regular basis, but when figures are going to be released the authorities notify the media with about a week's notice. By law, the NBS should be independent; in practice, however, this is not the case -- and therefore it is not able to verify adequately the quality of fiscal data. Commentators underscore the fact that the NBS collects data from each local government, but the latter typically alter their statistics before submission to make them appear more favourable. The central government then revises the statistics downwards to obtain more accurate, reliable figures. Overall, there is a lack of clarity as to the precise role of the NBS that needs to be addressed.<sup>61</sup>

## INTERVIEWS

Representatives of *Oxford Analytica* interviewed the following individuals during a visit to China between 17 and 21 November 2005:

### National Development and Reform Commission, Beijing

#### 20 November 2005

Zuo Chuan Chang	Deputy Director	Academy of Macro-Economic Research
Wang Yuan		Division of Fiscal and Financial Policy, Institute of Economic Research
Liu Guoyan	Associate Professor	Institute of Macro-Economic Research

Despite considerable effort to meet with someone from the Central Bank of China, *Oxford Analytica* was not granted an interview.

## ADDITIONAL INTERVIEWS

#### 17 November 2005

Zhang Xuechun	Senior Financial Economist	Head of External Relations, Asian Development Bank PRC Resident Mission
Jamil Anderlini	Beijing Business Correspondent	South China Morning Post

#### 18 November 2005

Tan Yaling	Senior Economist Professor Standing Director	Bank of China
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#### 19 November 2005

Ray Brooks	Senior Resident Representative	IMF
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#### 21 November 2005

Arthur Kroeber	Managing Editor	China Economic Quarterly
Brent Christensen	Senior Financial Officer	US Embassy

## NOTES

- <sup>1</sup> Constitution of the People's Republic of China (1982), Article 30, available at <http://english.peopledaily.com.cn/constitution/constitution.html>
- <sup>2</sup> "Governance: Progress and Challenges in the People's Republic of China", Asian Development Bank (ADB), p. 5.
- <sup>3</sup> Constitution of the People's Republic of China, Articles 57-62.
- <sup>4</sup> Constitution of the People's Republic of China, Articles 85-89.
- <sup>5</sup> Constitution of the People's Republic of China, Articles 123-131.
- <sup>6</sup> Constitution of the People's Republic of China, Article 7.
- <sup>7</sup> Interviews in Beijing, 17-21 November 2005.
- <sup>8</sup> Organisation for Economic Cooperation and Development (OECD), "China Needs Far-Reaching Reforms in Public and Corporate Governance", 7 September 2005.
- <sup>9</sup> "China: Managing Public Expenditures for Better Results", World Bank, April 2000, p. 39.
- <sup>10</sup> Interviews in Beijing, 17-21 November 2005.
- <sup>11</sup> IMF Working Paper Issues in Intergovernmental Fiscal Relations in China, February 2005.
- <sup>12</sup> "Governance: Progress and Challenges in the People's Republic of China", ADB, p. 21.
- <sup>13</sup> Budget Law of the People's Republic of China, 1994.
- <sup>14</sup> Interviews in Beijing, 10-12 November 2003.
- <sup>15</sup> IMF Article IV Consultation -- Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion, 17 November 2005.
- <sup>16</sup> "China: Managing Public Expenditures for Better Results", World Bank, April 2000, p. 53.
- <sup>17</sup> "Asset trading centres promoted for SOE reform", *Oxford Analytica Daily Brief*, 22 September 2004.
- <sup>18</sup> Interviews in Beijing, 1-5 November 2004.
- <sup>19</sup> Interviews in Beijing, 1-5 November 2004.
- <sup>20</sup> Interviews in Beijing, 1-5 November 2004.
- <sup>21</sup> State Administration of Taxation, available at: [www.chinatax.gov.cn](http://www.chinatax.gov.cn)
- <sup>22</sup> Wong, Christine, "Fiscal Decentralization in China: the Problematic Outcomes of Unplanned Changes in Transition Toward a Market Economy", Asian Development Forum, Bangkok, June 2001.
- <sup>23</sup> Interviews in Beijing, 1-5 November 2004.
- <sup>24</sup> Interviews in Beijing, 1-5 November 2004.
- <sup>25</sup> Interviews in Beijing, 17-21 November 2005.
- <sup>26</sup> One example of an improvement that should reduce tax evasion has been that restaurants must now issue computer receipts, with the computers linked to the tax offices. Wages are also now being audited and people must list their national ID numbers in order to get paid.
- <sup>27</sup> Interviews in Beijing, 17-21 November 2005.
- <sup>28</sup> Interviews in Beijing, 17-21 November 2005.
- <sup>29</sup> Interviews in Beijing, 1-5 November 2004.
- <sup>30</sup> Interviews in Beijing, 17-21 November 2005.
- <sup>31</sup> National Bureau of Statistics, at: [www.stats.gov.cn](http://www.stats.gov.cn); Ministry of Finance, at: [www.mof.gov.cn](http://www.mof.gov.cn)
- <sup>32</sup> "China: Managing Public Expenditures for Better Results", World Bank, April 2000, p. 65.
- <sup>33</sup> Interviews in Beijing, 10-12 November 2003.
- <sup>34</sup> "Recentralization in China?", IMF Working Paper No. 02/168, 2002; Interviews in Beijing, 10-12 November 2003.
- <sup>35</sup> Interviews in Beijing, 17-21 November 2005.
- <sup>36</sup> Interviews in Beijing, 17-21 November 2005.
- <sup>37</sup> Role of the Ministry of Finance, at: [www.mof.gov.cn](http://www.mof.gov.cn)
- <sup>38</sup> "Financial Management and Governance Issues in the People's Republic of China", ADB, 2000, Chapter VI: Government Budgeting and Accounting, p. 80, available at: [www.adb.org](http://www.adb.org)
- <sup>39</sup> "Technical Assistance to the People's Republic of China for Strengthening Public Debt Management", ADB, November 2002, p. 3; "Technical Assistance to the People's Republic of China for Fiscal Management Reforms", ADB, November 2002, p. 2.
- <sup>40</sup> "Financial Management and Governance Issues in the People's Republic of China", ADB, 2000, p. 80.
- <sup>41</sup> "Technical Assistance to the People's Republic of China for Fiscal Management Reforms", ADB, 2002.
- <sup>42</sup> "Governance: Progress and Challenges in the People's Republic of China", ADB, p. 16.
- <sup>43</sup> Interviews in Beijing, 1-5 November 2004.

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- <sup>44</sup> "IMF Country Report No. 04/351, November 2004," page 13.
- <sup>45</sup> Oxford Analytica Daily Brief, China, "Shortcomings Undermine Budget Relevance", 29 March 2005.
- <sup>46</sup> Oxford Analytica Daily Brief, China, "Shortcomings undermine Budget Relevance", 29 March 2005.
- <sup>47</sup> IMF Working Paper Issues in Intergovernmental Fiscal Relations in China, February 2005.
- <sup>48</sup> IMF Working Paper Issues in Intergovernmental Fiscal Relations in China, February 2005.
- <sup>49</sup> "Technical Assistance to the People's Republic of China for Fiscal Management Reforms", ADB, November 2002, p. 3.
- <sup>50</sup> Interviews in Beijing, 17-21 November 2005.
- <sup>51</sup> Interviews in Beijing, 17-21 November 2005.
- <sup>52</sup> Responsibilities of the Departments and Offices of the Ministry of Finance, at: [www.mof.gov.cn](http://www.mof.gov.cn)
- <sup>53</sup> Interviews in Beijing, 17-21 November 2005.
- <sup>54</sup> Interviews in Beijing, 10-12 November 2003.
- <sup>55</sup> Interviews in Beijing, 17-21 November 2005.
- <sup>56</sup> IMF Executive Board Concludes 2005 Article IV Consultation with the People's Republic of China, 3 August 2005.
- <sup>57</sup> Constitution of the People's Republic of China, Article 91.
- <sup>58</sup> "Development Management – Progress and Challenges in the People's Republic of China", ADB, 2002.
- <sup>59</sup> Statistical Law of the People's Republic of China (1983, revised 1986), Chapter 1, Article 1.
- <sup>60</sup> Interviews in Beijing, 17-21 November 2005.
- <sup>61</sup> Interviews in Beijing, 17-21 November 2005.